In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-42

CUBIC CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The sole question raised by the petition is whether the courts below correctly held petitioner to have realized ordinary income, rather than capital gains, under particular terms of a licensing agreement it entered into with a French company.

Petitioner is engaged in the development, manufacture, and marketing of equipment used to enable ground stations to track the position of objects in space. Although this equipment has potential for commercial uses, nearly 90 percent of petitioner's business has been with Federal agencies of the United States in the world-wide tracking system the National Aeronautics and Space Administration (NASA) established for its Project Mercury (Pet. App. A 1a-2a, Pet. App. B 1b; Ex. B, p. 5; Ex. C, p. 3).

In 1958, the French Government became interested in obtaining some of petitioner's equipment for the instrumentation of its missile range in Algeria. However, French officials deemed it important that a French concern be involved in the venture. Accordingly, they suggested that petitioner should also enter into some form of licensing agreement with technically qualified French businesses. After extensive negotiations, petitioner entered into such an arrangement with Compagnie des Compteurs (CdC) (Pet. App. B2b). The agreement provided that petitioner would supply CdC with the designs and know-how required to manufacture its equipment. While there were no foreign patents with respect to petitioner's equipment, petitioner granted CdC the exclusive right to sell and distribute certain items of its equipment within specified countries and a nonexclusive right to sell these items in others (Pet. App. B 2b-3b).

In the agreement, petitioner specifically reserved "the right to conduct business with all agencies of the United States Government in all parts of the world for any reason." CdC was required to "obtain prior authority" from petitioner before even making an offer to supply equipment to the United States for anything other than "Off Shore Funds." On labels attached to all the equipment CdC manufactured, it was required to identify itself as petitioner's "licensee." While the contract severely limited CdC's rights to release data and know-how pertaining to the licensed designs, it imposed no reciprocal restraints against petitioner's rights to release this unpatented data and know-how. Finally, CdC was prohibited from assigning its rights under the contract without petitioner's prior written approval (Pet. App. B 4b-5b, 9b; Ex. 34).

The contract provided for an initial payment by CdC of $275,000 and the further payment of a royalty upon

equipment manufactured under the agreement. Petitioner, however, agreed to accept $200,000 in lieu of the $275,000 initial payment if CdC ordered $700,000 of equipment from petitioner. CdC thereupon made an order of sufficient magnitude to meet that condition (Pet. App. B 6b).

The parties modifed the contract three times during the succeeding years, to grant CdC the right to manufacture and distribute more of petitioner's equipment,[1] to reduce the royalties under the licensing arrangement and to increase the area of CdC's "exclusive" territory. As consideration for these amendments, petitioner received an additional $175,000 (Pet. App. B 6b-7b).

Petitioner reported the entire $375,000 it received from CdC as capital gains. On audit, the Commissioner of Internal Revenue determined that this income was taxable as ordinary income and accordingly assessed a deficiency. In a refund suit brought by petitioner, both the district court and the court of appeals upheld the Commissioner's determination on the ground that petitioner had not conveyed all substantial rights to CdC under the agreement (Pet. App. A 1a-2a, Pet. App. B 1b-11b).

1. It is well established that consideration received for the transfer of unpatented rights and processes is not taxable at capital gains rates unless "all substantial rights" to those rights and processes are conveyed. See *e.g., Taylor-Winfield Corp.* v. *Commissioner*, 467 F. 2d 483 (C.A. 6), affirming 57 T.C. 205; *Pickren* v. *United States*, 378 F. 2d 595 (C.A. 5); *Bell Intercontinetnal Corp.* v. *United States*, 381 F. 2d 1004 (Ct. Cl.); *E.I. Du Pont de Nemours and Co.* v. *United States*, 288 F. 2d 904 (Ct. Cl.). Indeed, petitioner acknowledges (Pet. 8-17) the applicability of this rule. However, it challenges the decision below that it had conveyed less than "all substantial rights" in its contract with CdC.

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[1]Such additional equipment included that used by NASA in tracking its Project Mercury astronauts (Pet. App. A 2a; Ex. B, p. 5).

Petitioner first asserts (Pet. 7-12) that its reservation of the right to do business with the United States did nothing more than recognize the United States' preexisting rights to its equipment. It urges that because some of its equipment was designed under government research and development contracts, the United States was entitled to royalty-free access to those designs. Therefore, it contends, its reservation of the right to do business with the United States even in CdC's "exclusive" territory only gives contractual recognition to the United States' preexisting rights.

While a transferor's failure to convey such preexisting rights has, on occasion, been deemed not to alter the capital character of the transaction (*Bell Intercontinental Corp.* v. *United States*, *supra*; *Rollman* v. *Commissioner*, 244 F. 2d 634 (C.A. 4); cf. *General Aniline & Film Corp.* v. *Commissioner*, 139 F. 2d 759 (C.A. 2)), this case does not fit within the mold of those decisions which hold on their facts that all substantial rights were transferred. There is nothing in the record which demonstrates that the United States government had rights in all of the equipment covered by the license agreement. While the government's involvement in the initial development of certain of petitioner's equipment might have given it some rights in the resulting designs (II-R. 19-20),[2] the evidence showed that petitioner had made improvements to these designs over the years (II-R. 46).

The extent to which these design improvements were covered by the government's royalty-free license was never defined. It was stipulated that certain of the designs transferred to CdC were developed by petitioner, apparently without government assistance (I-R. 73). With respect to those designs, no rights would ever have

[2] "I-R." and "II-R." references are to volumes one and two of the duplicated record in the court of appeals.

vested in the government. Moreover, whatever rights the federal government possessed could have been fully protected by petitioner's waiver of all royalties on equipment produced by CdC for the United States government. That petitioner chose instead to reserve for itself all business with the United States shows that petitioner intended to and did convey less than all substantial rights in the designs and know-how to CdC. The cases cited by petitioner (Pet. 8-9) as conflicting with the decision below are distinguishable on account of petitioner's reservation of substantial rights.

2. Contrary to petitioner's further argument (Pet. 12-15), the decision below did not look outside the territory exclusively granted to CdC in concluding that not all substantial rights were transferred. Indeed, even the territory granted CdC was hardly "exclusive" in light of the well-known international scope of United States' space programs. The possibility of federal activity within the territory "exclusively" granted CdC could hardly be called remote.[3] Petitioner's equipment, rights to which it transferred to CdC,[4] had been used by NASA in what petitioner described as a "globe-girdling" network of tracking stations[5] (Ex. E, p. 6). Thus, it was clear to both courts below that even within the "exclusive" territory granted to CdC, petitioner's reserved rights were substantial.

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[3]In the end, the so-called "exclusive" territory encompassed nearly all of Europe and the Middle East (Pet. App. B 6b; Ex. 64).

[4]Petitioner's statement that the equipment used in Project Mercury was not sold in the 1960 agreement is misleading. This equipment, known as the AGAVE system (Ex. C, p. 6; Ex. D, pp. 1, 6), was included in the licensing agreement in a subsequent amendment (Ex. 54).

[5]Petitioner asserts (Pet. 5, 14-15) that the licensing provision authorizing CdC to compete for governmental business that was to be transacted with "Off Shore Funds" effectively meant that CdC could compete for all United States procurements abroad. This interpretation of the licensing agreement is not warranted by its

Nor was there a need to look to anything other than the economic value of this reservation. Agencies of the federal government were petitioner's chief customers, accounting for nearly 90 percent of its business (Ex. B, p. 5; Ex. C, p. 3). The government's involvement in activities abroad gave the threat of foreign competition real substance. Petitioner accordingly drafted the reservation clause in order to meet this challenge of foreign competition. It included, first, an unqualified reservation of United States business, then required CdC to obtain prior authority for any United States business it might choose to seek (in apparent violation of the prior reservation), and finally required notification from CdC of the imminence of CdC's doing business with the government. Petitioner thus had a triple check on CdC. In seeking to

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terms. Petitioner specifically authorized CdC to compete freely only for those United States programs which were funded with "Off Shore Funds" (Ex. 34, pp. 2-3). While funds appropriated for Department of Defense procurement may be expended abroad (see Pasley, *Offshore Procurement*, 18 Military L. Rev. 55, 59 (1962)), these general procurement funds do not fall precisely within the description "Off Shore Funds." The federal government does, however, hold excess foreign currency, which can only be expended abroad. *E.g.*, Act of August 26, 1954, c. 937, 68 Stat. 832, Section 502 (22 U.S.C. 1754); Act for International Development of 1961, 75 Stat. 424, Section 612 (22 U.S.C. 2362). These funds come much closer to meeting the classification of "Off Shore Funds" than do general procurement funds, for they are irrevocably "Off Shore." But as a domestic corporation, petitioner could not have competed for these foreign funds in its own rights and therefore gave nothing of value to it when it transferred to CdC the right to seek "Off Shore Funds." Indeed, the only way it could profit from procurement made with such funds was through CdC's royalty payments.

have this reservation classified as insubstantial, petitioner has denied the terms of its own contract.[*]

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

SEPTEMBER 1974.

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[*]Furthermore, it is apparent on the face of the licensing agreement that petitioner did not grant CdC the control over the release of the unpatented design data and know-how which is essential to its exclusive possession. Absent such a grant, the transaction does not qualify for capital gain treatment. *E. I. duPont de Nemours and Co. v. United States*, 288 F. 2d 904, 912 (Ct. Cl.); *Commissioner of Internal Revenue v. Corn Products Refining Co.*, 350 U.S. 46, 52; *Hygrade Corp. v. Commissioner*, 42 T.C. 455, 468-469.

Moreover, the record demonstrates that petitioner viewed the agreement with CdC simply as a vehicle for increasing its sales of tracking devices (III-R. 183). The resulting income arising from the day-to-day operation of petitioner's business is not entitled to capital gains treatment. *See Corn Products Co. v. Commissioner*, 350 U.S. at